

How Accession to the European Union Has Affected External Trade and Foreign Direct Investment in Central European Economies

Bartłomiej Kaminski

During the Central European countries' reintegration into the world economy, their proximity and accession to the European Union greatly affected first the flow of capital and then the flow of goods. Countries that adopted radical liberal reform and had preferential access to EU markets have benefited most, attracting foreign direct investment and drawing multinational corporations relocating their production sites.

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Summary findings

The collapse of central planning set in motion the reintegration of the Central European countries into the world economy. The European Union, because of its proximity, economic weight, and policy-induced deep integration, has shaped these countries' politics and economics. The process of accession to the EU—which began with the signing of the European Association Agreements in 1991—has influenced their economic institutions, policies, and performance.

Kaminski traces the emerging architecture of commercial relations in Europe and argues that the accession process had its greatest impact first on capital flows and later on goods flows.

The countries that have benefited most from accession are those that followed the path of radical liberal reform. Radical liberal reform, combined with preferential access to EU markets, attracted foreign direct investment.

The European Union provided an outlet initially for Central European countries' unskilled-labor-intensive products and more recently for skilled-labor-intensive and technology-based products.

Knowledge-intensive imports from the European Union have also contributed to industrial realignment in the Central European countries. The prospect of accession and, since 1998, unfettered access to EU markets for industrial products has given a boost to multinationals relocating production in these countries.

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by

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List of Acronyms

CAP	Common Agricultural Policy
CEFTA	Central European Free Trade Agreement
CEECs	Central European countries include Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic and Slovenia.
CET	Common External Tariff
CN	Combined Nomenclature
CMEA	Council for Mutual Economic Assistance
EA	Europe Association Agreements
EFTA	European Free Trade Area
EEA	European Economic Area
EU	European Union
FDI	Foreign Direct Investment
FTA	Free-trade Agreement
GDP	Gross Domestic Product
GSP	Generalized System of Preferences
MFN	Most Favored Nation
MNC	Multinational Corporation
NAFTA	North American Free Trade Agreement
NTBs	Nontariff Barriers
SITC	Standard International Trade Classification
WTO	World Trade Organization

Introduction

The EU responded to the collapse of communism in Central Europe by providing aid and offering preferential arrangements initially solely in terms of market access. The EU first ‘upgraded’ status of CEECs to that of the least developed countries by granting them GSP and soon thereafter signed the EA. The EA went well beyond narrowly conceived issues of market access by opening the path of deep, policy-induced integration. Having recognized that the ultimate goal of CEEC signatories of the EA is full membership in the EU, they have in fact set up a foundation for the accession process. The countries that made the fastest progress in transition—the Czech Republic, Estonia, Hungary, Poland and Slovenia—were already invited in July 1997 to begin accession negotiations (these started in March 1998), whereas “late” or slower reformers—Bulgaria, Latvia, Lithuania, Romania and the Slovak Republic—joined the former in December 1999.¹

Although the policy-induced integration—i.e., integration supported by special agreements extending beyond WTO-negotiated arrangements—of CEECs into the EU falls into a North-South type of preferential arrangements, it goes much further. Expansion of NAFTA to include Mexico and a network of special agreements tying several developing countries to the EU illustrate a wide array of new forms of North-South integration. The accession process that began with the EA is a distinct preferential arrangement. It is more than a free trade (e.g., NAFTA with a possible extension to Chile), a customs union (e.g., the EU and Turkey), and even more than association agreements implying deeper integration (e.g., the European Union and Mediterranean countries) as CEECs are already involved in accession negotiations. The process is similar to that of enlargement of regional agreements through accession, i.e., the EU accession of Greece, Portugal and Spain. It implies full convergence of their domestic systems to the EU *acquis communautaire*, that is, the comprehensive body of laws, rules and regulations that govern the Union.

Considering the envisaged depth and scope, returns usually associated with integration into a “Northern” regional bloc should be high. The most important potential benefit related uniquely to ‘policy-induced’ integration of a poor country into highly developed economies is that the former can become like the latter in terms of economic institutions and policies. Although institution-building takes time, the accession process exerts enormous pressures and creates

¹ This first—also including Cyprus—is often called the “Luxembourg Group,” whereas the second is referred to as the “Helsinki Group.” The latter also includes Malta.

incentive to move faster especially once accession negotiations begin. It also gives an extra ammunition to overcome political resistance to the overhaul of old rules of economic game.

Thus, it seems that the importance of the policy-induced integration into the EU stems mainly from the alignment of their economic systems with the EU archetype, i.e., complementary reforms.² These institutional measures include among others laws on competition, company law, company accounts and tax regulations, banking law, laws on mergers and state aid, intellectual property law, rules of indirect taxation, transport and environment laws.³

Enhanced credibility of commitment to liberal economic policies and improved market access are the source of standard returns from North-South type integration to a “Southern” partner. These usually include increased flows of trade as well as of direct and portfolio investments as investors face lower institutional and policy risks due to improvement in a country’s business climate. For instance, the gradual adoption of the *acquis* has already vastly contributed to the improvement in business climate and made CEECs more attractive to foreign and domestic investors alike. In addition, circumventing tariffs of a “Northern” country thanks to the free trade agreement provides an extra incentive to foreign firms to invest. The enhanced-growth potential of a country usually results in higher growth of real GDP.

Sorting out which factors related to policy-induced integration are accountable for policies pursued by a “southern” economy and their outcomes is always an arduous task. But it is particularly difficult in the case of CEEC integration into the EU. For one, integration-induced effects are impossible to separate from those stemming from dismantling central planning. The 1989-91 period witnessed rejection by CEEC societies of the political and economic system that Stalin had imposed on them. Thus, the movement in the direction of liberal capitalism as exercised by highly developed countries was inevitably part of the initial transition.

The shift in their commercial relations towards the EU was also bound to happen. For all of them the EU has always been potentially both the largest trading partner and the most important source of capital and technology. However, as long as politics had determined CEECs’ external relations, this potential could not be activated and the Council for Mutual Economic Assistance was their major partner. With the collapse of central planning, that is, once external commerce has finally become subordinated to economic considerations and state monopoly over

² This should not imply the irrelevance of trade component of EAs. The point is rather that liberalization in conditions of access to markets for commodities without concomitant structural reforms would only result in exits from trade-related disciplines of EAs.

³ These institutional and regulatory requirements are similar to the treaty between the EU and EFTA, establishing in 1992 the European Economic Area. In a marked contrast, however, the Europe

foreign trade was abolished, the EU has quickly emerged as their largest trading partner. This outcome was bound to occur with or without a network of special preferential arrangements, albeit they certainly helped CEECs' firms in marketing their products in the EU.

While initially the pace of trade reorientation towards the EU depended largely on the pace of liberalization and the extent to which a CEEC had "undertraded" with the EU under central planning (Kaminski, Wang and Winters, 1996), subsequently industrial realignment has become crucial to sustainability of trade expansion. Access to FDI combined with business climate favorable to private sector development has shaped the dynamics of industrial restructuring. In this way, the accession process appears to have had significant impact on structural reforms and FDI inflows.

The effectiveness of the policy-induced integration process to lock a country in a virtuous circle of liberalizing economic reforms hinges critically on its scope and depth as well as punishment mechanisms for exits. At the initial stages, the EU did not seem to have had a significant impact on reforms in CEECs for two reasons. First, the EA were devoid of incentives to reward them for moving quickly in transition to a market-based democracy and exercise restraint in macroeconomic management. They also offered many easy exits and, perhaps more importantly, lacked a well-defined promise of membership.

Second, the EAs were signed after most CEECs had already launched their respective stabilization-cum-transformation programs. Hence, the EU could not play a direct role, albeit its imports somehow lessened the pain of the adjustment inflicted by the collapse of CMEA import demand and the shift towards a new economic regime.⁴

At the later stages, however, the impact of the EA on economic policies of CEECs had become more explicit. In addition to the ongoing harmonization of domestic economic institutions and policies with those of the EU, regional liberalization of foreign trade can be directly attributable to the EA-initiated process of accession. The trade provisions of EAs have obliged CEECs to open their markets to EU imports and the EU have induced CEECs towards

Agreements proscribe the free movement of labor during the first five years and, after that time, promise only an examination of the situation.

⁴ There is one caveat, however. For slow and gradual reformers, the EU factor has played a significant role in strengthening political coalitions favoring radical economic reforms. Public fears that government policies jeopardized prospects for accession to the EU seem to have tipped the political balance in favor of reformers in Bulgaria, Romania and Slovakia, albeit it remains to be seen whether they will survive the next round of parliamentary elections. New governments undertook liberal reforms and the desire to converge to the *acquis* has been their guiding principle. With the move to accession negotiations, the process has become more orderly (negotiations of chapters) and the EU's role in shaping institutional change and policies has been expanding.

elimination of trade barriers among themselves. In consequence, by the end of 1990s around 80 percent of CEECs' imports of industrial products were not subject to tariffs.

The reminder of the paper is organized as follows. Section 1 discusses the emergence of a new pan-European framework for trade in industrial products and the twin impact of the EA-driven integration process on foreign trade policies in CEECs and on EU foreign trade policies. Section 2 reviews the realignment in CEECs foreign trade during transition with the emphasis on its trade with the EU and the role of FDI in integration into the EU. Section 3 seeks to assess the role of the policy-driven integration in attracting FDI and their impact on trade integration of CEECs into the EU. The last section concludes.

1. Emerging 'Pan-European' Framework for Commercial Interaction

The process of the policy-induced integration of CEECs into the EU, initiated by the EA, has already led to the emergence of a single framework for trade in industrial products among European Economic Area countries and CEECs. The framework provides for free trade in industrial products as of January 1, 2002. Its emergence is the result of several developments all driven by the combination of CEEC aspiration to become EU-members and EU's incremental accommodation to CEECs pressures.

The trade component of the EA has shaped trade policies of CEECs. It committed CEEC to remove gradually, over a period of maximum ten years, tariffs and other barriers to imports from the EU. Since the EU, because of its proximity and huge size in terms of GDP has always been potentially (i.e., once CEECs become "ordinary" market economies) the largest trading partner for CEECs, liberalization in market access for EU suppliers amounted to a dramatic increase in competition from imports in CEECs. With the extension of similar arrangements to EFTA and other CEEC economies, the proportion of trade subject to preferential treatment has further increased.

The proliferation of EAs has set the EU on the path towards establishing a single trading area in industrial products. First, in order to stimulate trade among CEECs aspiring to become EU members, the European Commission prodded them to sign bilateral free trade agreements for industrial products. Second, complications created by the emergence of a network of overlapping free trade areas around the EU pushed the European Commission to seek harmonization rules of origin among European partners of EU-inspired FTAs. The major outcome of these two developments will be a single free trade area (to be fully in place on January 1, 2002) in industrial products linked through a system of diagonal cumulation (WTO 1997).

1.1. “EU factor” in foreign trade policies of CEECs

Initially both the approach to economic reforms and accession to the EU shaped foreign trade institutions and policies of CEEC economies. The two had reinforced each other, but only for these countries that took the radical approach to economic reforms. Then, the process of institutional alignment with the requirements of the *acquis* served as a basis for domestic transition in CEEC countries towards a market based economy. With the progress in the integration process and harmonization of economic regimes with the *acquis*, integration framework’s impact on foreign trade institutions and policies has increased. So has its impact on contestability of domestic markets, as the process compelled CEECs to open their markets to competition from preferential partners.

As a matter of economic logic, the best policy choice for a country is to integrate fully into the global economy. But a special relationship with certain developed countries may increase international competitiveness and yield welfare enhancing benefits to a developing country. There is no conflict between regional integration and unilateral liberalization. In fact, benefits from regional arrangements may be even larger when supported by unilateral liberalization and deeper integration. It has been shown that the combination of integrationist arrangements with developed countries and unilateral trade liberalization increase these benefits even further.

Regional liberalization

Regional agreements with the EU were clearly the most attractive policy option to CEECs. Because of its size and geographical proximity, the EU is their largest trading partner—both as a potential huge importer as well as supplier of knowledge-intensive products. Thus, liberalization in conditions of market access for EU firms has dramatically increased competition from imports to CEEC domestic producers as well as availability of high quality products to consumers.⁵

But the EA’s trade component *per se* could not assure the emergence of a good trade regime, that is, one that would tame special interests of politicians and import-competing sectors, which is a litmus test for the quality of foreign trade institutions and policies. Its provisions aimed mainly at areas affecting market access and trade between CEECs and the EU. But even in these areas they suffered from two weaknesses: First, they would not infringe unless there was deterioration in market access for EU firms. For instance, highly disruptive administrative

⁵ Opening to the EU has increased the capacity of CEEC firms to compete in international markets. Note that several studies show that new products of higher quality have been behind the expansion of CEECs exports to the EU. See, for instance, Djankov and Hoekman (1997), Barba Navaretti et al. (2000).

practice of discretionary tariff exemptions was allowed to persevere. Second, they offered CEECs the exit option through various safeguards allowing for a temporary suspension of disciplines. Yet, CEECs—except for Poland—have rarely resorted to safeguards. Hence, neither of these two weaknesses had a serious negative impact on CEECs' foreign trade regime vis-à-vis the EU.

The impact of accession was initially the largest on tariff policy, as the EA and subsequent amendments obliged CEECs to remove tariffs on industrial products over a period of ten years. First, the EA initially “froze” tariff rates of CEEC imports from the EU by adopting the standstill principle. Once the Interim Trade Provisions of the EA went into effect neither new duties nor any other charges with similar effects could be implemented. Second, CEEC zeroed tariff rates on around 30 percent of Combined Nomenclature items upon the entry in force of EA trade provisions. Third, for the remaining industrial products there were different schedules gradually lowering tariffs. In 2000 around 90 percent of CEEC industrial imports from the EU were not subject to tariffs. Tariffs will be fully removed by 2002.

But the accession process has also shaped CEECs' foreign trade policies with each other as well as other trading partners. Not unlike the EU in its foreign trade policy, each CEEC had become enmeshed in a web of bilateral FTAs. Two kinds of FTAs can be distinguished: those signed among CEECs themselves and preferred partners of the EU with EFTA at the top, and, on the other hand, these signed by CEECs with “non-accession” partners. The distinction is important for two reasons: because of negative implications that CEEC accession to the EU may have on their trade with “non-accession” countries, and because the former agreements set the groundwork for smooth accession to the EU, albeit with a caveat.⁶

As for the first kind of FTAs, i.e., among preferred European partners of the EU, the EFTA countries signed the preferential trade agreements with CEECs on average within a year after the EA had gone into effect. The preferential trade agreements with EFTA were modeled after the EA. The first preferential agreement among CEECs was CEFTA, which entered into force in 1993. Its membership gradually expanded over time.⁷ Baltic states signed FTA among themselves in 1995. There were also other bilateral agreements with countries that have

⁶ The caveat is that FTAs signed among CEECs usually have more liberal foreign trade regime for agricultural products than that of the EU, although additional agreements on trade in agricultural products signed with the EU in 1999-2000 have been closing the gap. Yet, different dates of accession to the EU may create conflicts among CEECs left behind unless CAP is overhauled.

⁷ The CEFTA signed in 1992, provides a framework for bilateral agreements among seven states: the Czech Republic, Hungary, Poland, Slovakia, Slovenia (which acceded in 1996) and Romania (which acceded in July 1997). More precisely, the CEFTA system has two components: a multilateral and bilateral. A multilateral component comprises commonly agreed preferences, whereas a bilateral one those negotiated bilaterally and not extended to all CEFTA members.

preferential arrangements with the EU. Most CEECs either have or are about to sign FTAs with such EU preferential partners as Turkey, Israel, and Morocco.

As for the second type of agreements, a number of CEECs concluded FTAs with “outsiders.” For instance, Slovenia has FTA with Croatia and Bulgaria with Macedonia. Although the status of these FTAs is unclear upon CEEC accession to the EU, “outsiders” may become included into the EU expansion scheme. For instance, the EC has included Albania, Bosnia and Herzegovina, Croatia, and Former Yugoslav Republic of Macedonia in the so-called Stabilization and Association Process specifically designed for Western Balkan countries. The EC has recently accorded these countries preferential access for most tariff line to EU markets.⁸ Hence, CEECs’ FTAs with these countries are not likely to complicate their commerce once they become members of the EU and adopt EU’s common external tariffs.

Reverse discrimination

Although contestability of CEECs’ domestic markets has significantly increased as a result of regional liberalization, trade diversion due to growth in discrimination against MFN imports was likely to occur. Reverse discrimination, i.e., the difference between MFN and preferential rates has increased while conditions in market access for preferential supplies have improved. In 1999 around 85 percent of all industrial imports were duty free and this percentage will increase with the removal of all tariffs on industrial imports in 2002. Although CEECs have reduced tariff rates under the Uruguay Round Agreements, for most of them the fall in preferential rates was steeper than in MFN rates indicating an increase in the levels of reverse discrimination. The fall in the share of MFN suppliers in industrial imports of CEECs from 100 percent in 1991 to around 10-15 percent can be attributable to some degree to trade diversion. While its scope has been rather limited because of the economic size of the EU and geographical proximity among CEECs, it would have been considerably lower had CEECs lowered their MFN tariffs on industrial products to EU’s applied MFN tariff rates.

But this has not happened so far. Although almost all CEECs have MFN tariff rates on industrial products significantly higher than the EU, not a single CEEC has sought to align them with the tariff rates in the EU (Kaminski 1999). With two exceptions of the Czech and Slovak Customs Union and Estonia, their MFN rates on industrial products remain significantly larger

⁸ The Europe Council Regulation No. 2007/2000 (18 September 2000) has considerably widened trade preferences already applied by removing the remaining tariff ceilings for industrial products and by improving conditions in access to EU markets for agricultural products. It was reported that identical preferences the EU would grant soon to FYR Macedonia (Agence Europe, Brussels, 20 September 2000).

than in the EU. But only in Estonia free trade regime has been the outcome of strong free trade sentiments among political elite. The former Czechoslovakia, a founding member of GATT, inherited low MFN rates from tariff concessions made earlier by its communist regime in GATT multilateral trade negotiations. These were irrelevant then as a central plan rather than independent traders determined imports.

Concluding comment

It is rather odd that other CEECs have not aligned their MFN applied tariff schedule on industrial imports with that of the EU. Consider that such a move would make economic sense without triggering political opposition. For one, there is a strong 'reverse discrimination' argument in favor of adopting EU MFN applied rates as victims of reverse discrimination are not only MFN suppliers but also domestic users of imports—consumers and producers alike.⁹ Second, there is no compelling political economy argument against alignment of tariffs as CEECs have already either lowered or eliminated tariff rates on industrial imports from the EU in accordance with the provisions of the EA. Since most domestic producers of industrial goods are already exposed to tariff-free competition from EU imports, the alignment of MFN tariff rates with those in the EU would encounter little, if any domestic opposition. Furthermore, the 'bargaining' argument vis-à-vis other WTO members does not apply, as the move would not affect negotiated MFN tariff rates. These would remain at the same level, whereas lower EU rates would be applied unilaterally.

Given this revealed reluctance to engage in multilateral liberalization, one may conclude that the levels of opening of CEEC markets to external competition would have been considerably lower in the absence of the EA-driven process of European integration. The protectionist impulses of economic bureaucracies in many CEECs seem to have been contained by the imperative of accession and fears of retaliatory measures by the Commission, albeit not always and not fully. Without the imperative of regional liberalization in the context of EU accession, competition from imports in most CEECs would have been much weaker with significant losses in terms of microeconomic efficiency and consumer welfare. This seems to be a very important gain from the accession process.

⁹ High preferential margins increase the potential for trade diversion often to more expensive suppliers in the EU. They seem to have been the main beneficiaries of this provision, as high tariff rates kept competitors from non-EU countries at disadvantage.

1.2. CEEC Factor in EU trade policy: towards a new pan-European commercial setting

While there is a large body of literature on political and economic aspects of adjustment,¹⁰ the fact that the policy-induced integration of CEECs into the EU has produced a new institutional framework of European relations remains largely unnoticed. The framework is the result of the evolution of EU trade policy driven in large part by its desire to accommodate accession aspirations of CEECs. More specifically, it can be regarded as the response of the EU to complications created by the emergence of a network of overlapping free trade areas and the need to harmonize rules of origin among European members of EU-inspired FTAs. The process had two components: harmonization in liberalization of trade in industrial products and “regionalization” of rules of origin. Its major outcome will be a single free trade area (to be fully in place on January 1, 2002) in industrial products linked through a system of diagonal cumulation (WTO 1997).

Although trade components of EAs with some CEECs went into effect on different dates ranging from 1992 (former Czechoslovakia, Hungary and Poland) to 1996 (Slovenia), schedules of elimination of duties and NTBs on industrial products had one important component in common. They all had January 1, 2002 as the date to complete the process of liberalization. Similarly, elimination of duties on industrial products did not go beyond these dates in all other bilateral free trade agreements signed among CEECs. In consequence, the pace of liberalization has been harmonized in terms of the date of the emergence of a pan-European free trade area in industrial products.

“Regionalization” of the rules of origin has gone through more complex process. The FTAs are usually bilateral agreements envisaging the establishment of free trade area between two or more countries and providing for bilateral cumulation of origin between parties of the FTA. FTAs have to specify conditions that products must meet in order to take advantage of preferential treatment. If “outside” imports embodied in a product exported to another partner of the FTA exceed a certain threshold, this product is subject there to MFN rather than preferential tariffs. This arrangement is more advantageous to a larger partner in the FTA, as its firms can draw upon a larger pool of local inputs.

The EA initially did not diverge from this practice. They were bilateral agreements between a CEEC and the EU. By the same token, imports from say Hungary processed in Poland but not in the extent to meet the EA rule of origin criterion and exported to the EU were treated as

¹⁰ The seminal study is Baldwin, Francois and Portes. (1997).

“external” imports.¹¹ Since the EU is larger than any single CEEC or their aggregate, this arrangement was clearly more advantageous to firms from the EU than for firms from a CEEC, albeit with a caveat. It prevented large MNCs from establishing production networks across CEECs.

The sheer number of FTAs with CEECs further exacerbated problems and reduced potential benefits to transition economies. Because of the European Economic Area establishing the common market for EU and EFTA countries, the latter had little choice but to negotiate free trade agreements with CEEC. These were modeled after the EA, as EFTA firms wanted to enjoy the same access to CEEC markets as firms from the EU in order to compete with them on equal footing. Both the EA and FTAs of EFTA with each CEEC had very similar rules for determining whether a product would qualify for preferential treatment. They provided for bilateral cumulation of origin between the EU or EFTA and the beneficiary CEEC.

While the EU- and EFTA-CEEC FTA rules of origin were a carbon copy of arrangements between the EU and EFTA, their practical implications were different for CEEC-firms. Consider first that EU-EFTA arrangement, i.e., the European Economic Area, was different from EA. The former was based on a bilateral cumulation between the EU and EFTA as a whole rather than each CEEC, whereas the latter on bilateral cumulation between the EU and each CEEC. Similarly, FTAs between EFTA and each CEEC were based on the same rule.

Second, although both the EA and FTAs with EFTA facilitated commercial interaction, their major beneficiaries were firms from the EU and to a lesser extent from EFTA, as the latter was a much smaller economy in aggregate. The EA have thus led to the emergence of the so-called hub-and-spoke pattern putting spoke (CEEC) firms' at a disadvantage vis-à-vis hub (EU or EFTA) firms (Baldwin 1994). The latter could use inputs originating in either other EU- or other EFTA-member countries to qualify for preferences, whereas the former could not use imports from EFTA or other CEEC(s) to qualify for preferences in the EU. Similarly, CEEC firms could not use inputs from EU firms to qualify for preferences in EFTA markets.¹² Since the industrial base of either the EU or EFTA is dramatically larger than in any of a single CEEC, this

¹¹ Because of asymmetry in respective schedules of tariff reductions by the EU and CEEC, the advantage of EU/EFTA firms was eroded until around 1997 when CEEC tariff reductions on EU industrial imports became meaningful.

¹² Rules varied depending on a product. Preference was granted to textiles if it was produced in a free trade area from fabric also originating in a free trade area. For machines, a 70 percent value-added rule applied or 60 percent with an additional condition that all imports from outside would undergo a change to the tariff position of the machine according to the HS (Harmonized System). Since specific parts were generally classified in the same heading of the HS as the machines in which they were merged, this condition was rarely met (Nell 1997).

arrangement has offered strong advantage to EU/EFTA firms at the expense of CEEC firms. It was easier for the former to claim preferences in access to CEEC markets.

Third, bilateral cumulation of rules of origin in CEECs' FTAs with the EU and EFTA created disincentives to use inputs originating in separate free trade areas, which reduced potential advantages enjoyed by EU firms and, ironically, it further depressed benefits of EA to CEECs. These arrangements erected a barrier to the development of trade based on fragmentation of production, i.e., moving across border various fragments of a supply chain, which has been the most dynamic component of international trade over the last decade (Feenstra 1998). For instance, a machine tool produced by a Swiss firm using parts originating in CEECs would not qualify for duty-free access in EU markets. And the same Swiss machine using inputs originating in EU might not qualify for preferential access to CEEC markets, as EU parts were considered as third-country material.

Hence, the rush to establish FTAs with CEEC produced the partition of Europe in terms of commerce, which—although organized around the EU—was detrimental to interest of EU businesses as well as those in EFTA and CEEC economies. Many EU and EFTA firms have been in various vertical and horizontal production arrangements for a long time. Their joint products would not qualify for preferential treatment in CEEC markets. Furthermore, EU firms interested in either outsourcing or moving various stages of production to different CEEC would face the prospect of paying duties on their import into the EU. Nell (1997) notes that the system had become so messy that Western European industry supported measures that would eliminate obstacles to trading across preferential zones.

Attempts to address these deficiencies had led first to CEEC acceptance of new rules of origin based on the rules applied in European Economic Area linking EU and EFTA countries. With the establishment of CEFTA, these rules were extended to three Visegrád countries (former Czechoslovakia, Hungary and Poland). Trade with these countries thus became based on diagonal cumulation of origin with a single trading zone having had replaced three separate zones each having bilateral ties with the EU. Instead of extending the rule of diagonal cumulation to all CEECs and the EEA,¹³ the European Commission requested that CEECs sign FTAs among themselves and the EU Council adopted the so-called pan-European cumulation program in July 1996. The program envisaged signing of the pan-European Cumulation Agreement that would

¹³ After the establishment of CEFTA by these three countries in 1992, the European Commission introduced diagonal cumulation allowing for the use of inputs originating in any CEFTA member to qualify for preferences. In 1996 only the Czech Republic, Hungary, Poland and Slovak Republic had diagonal arrangement with the EU. The remaining six-CEECs had arrangements based on the principle of bilateral cumulation.

link CEECs and European Economic Area countries through a system of diagonal cumulation allowing imports in these countries to be treated as local inputs (WTO 1997).

The Pan-European Cumulation Agreement, which went into effect on January 1, 1997, has set the stage for formation of a single European trading bloc. In addition to extending rules of origin to all European associates of the EU, it has also standardized trade components of EA as well as newly signed agreements in terms of the date of removal of tariffs and non-tariff barriers by the end of 2001. In consequence, a single pan-European trading zone will become in 2002 a free trade zone for industrial products encompassing 29 countries.¹⁴

This arrangement has two major advantages. First, with or without quick EU membership, CEEC exporters already have preferential access to industrial product markets encompassing around 490 million consumers. Second, the Agreement strongly encourages the development of assembly operations, outward processing, outsourcing and transfer of production facilities within the enlarged area. This is particularly important in such production and marketing networks as telecommunication, audio-visual and automobile production where these are already conducted on a significant scale. Another potential beneficiary is outward processing in the textiles and clothing (WTO 1997:61).

Hence, in retrospect, the interim trade component of the EA has turned out to be more important than anybody might anticipate when it went into effect in March 1992. It was a beginning point of a process that has set a new framework providing strong incentive to economic integration within the European continent. This strikes one as a huge, even though originally unanticipated return from regional integration, to both the EU and CEECs.

1.3. New trade framework and accession

The emerging framework for free trade in industrial products encompassing 'old Western Europe' and ten CEECs provides a good vehicle for integration and economic growth. However, the framework has a serious structural flaw related to the exclusion of agricultural products further compounded by the exclusion of some European countries from the framework. The latter may create friction between CEECs and "non-EU" associates once they become members, whereas the former may emerge if CEECs are not admitted in a bundle to the EU.

Scattered accession may create significant economic dislocation in agricultural sectors in countries still awaiting accession, simply because bilateral preferential trade agreements that each CEEC has signed are more friendly towards free trade in agricultural products than the EU's

¹⁴ The countries covered by the framework are Bulgaria, the Czech Republic, Estonia, Hungary, Iceland, Latvia, Lithuania, Norway, Poland, Romania, the Slovak Republic, Slovenia, Switzerland, Turkey and 15-EU members.

Common Agricultural Policy. The extreme case would be the admission of the Czech Republic while Slovakia is left behind. The Czech Republic would then have to adopt the EU's external tariffs. This would not be a problem for Slovak firms producing industrial products as these already enjoy unfettered (duty-free) access to EU markets. But the customs union agreement between the Czech Republic and Slovakia includes also agricultural products. If Slovakia were left behind, its farmers would lose free access to Czech markets and would have to compete on unequal footing with subsidized EU agricultural products.

The extent to which scattered accession imposes adjustment costs on countries that would have not been included by the European Commission in a given round of accession will depend on the pace of lifting duties and other constraints in agricultural trade. In 2000 the EU signed bilateral agreements with several CEECs removing tariffs on "nonsensitive" agricultural products (e.g., vegetables, fruits, mushrooms, livestock, horse meat) and raising duty-free quotas on "sensitive" agricultural products such as wheat, poultry, pork products and some dairy products.¹⁵ This should weaken the negative impact of scattered accession.

Notwithstanding the choice of the mode of accession by the EU, the adoption of the EU CET on all products will negatively influence other countries with which a CEEC has FTA. Provided that agricultural trade is subject to less stringent conditions than under CAP, even a country that has FTA with the EU will be negatively affected.

Hence, the CAP agricultural regime remains also a barrier to smooth regional integration. Reform of the CAP and concomitant liberalization in conditions of access to EU agricultural markets would go a long way to reduce the potential for trade conflicts in Europe. So would the inclusion of some countries that have been so far excluded from the Pan-European single trading bloc projects—especially those from the former Yugoslav space.

2. Readjustment in trade patterns

It is an impossible task to identify with any precision the extent to which preferential access to EU markets was responsible for reorientation in geographic patterns of trade of CEEC. Under central planning they undertraded with the EU and overtraded with each other and other members of the former CMEA. A sizable portion of the adjustment can be attributable to the correction in earlier trends. Yet, although it would be impossible to put any figure on it, the preferential access has certainly contributed to the shift towards manufactures. These products

¹⁵ Agreements, although drawn upon within the framework of EA, differ among themselves reflecting "competitiveness" of CEECs in agricultural production. They are, however, substantive liberalizing between half and two-thirds of countries' agricultural exports to the EU.

have enjoyed preferential treatment in EU markets since the outset of transition. Change in directions of trade, the composition of exports and factor content of CEEC exports capture the scope of adjustment that CEECs underwent in the 1990s and provide important insight into benefits from policy-induced integration with the EU.

2.1. Significance of preferential access

While the shift from a supply-constrained economic regime to a demand-constrained regime combined with the collapse of import demand in CMEA has been the major force behind the expansion of CEEC-EU trade, the measures introduced by the EU to support transition and accelerate re-integration of CEECs into EU markets have also contributed to trade expansion. Consider the following. First, in the aftermath of the 1989 revolutions the EU granted GSP status—bypassing their "state trading" qualification—first to Hungary and Poland (1990), then to Bulgaria and former Czechoslovakia (1991), and subsequently to Estonia, Latvia and Lithuania (1992). Romania had GSP status since 1973. GSP status gave them the same conditions in access as those enjoyed by least-developed countries. Slovenia retained preferential status for its exports under the so-called autonomous trade preferences granted by the EU to Yugoslavia in the 1980 Cooperation Agreement.¹⁶

The GSP status significantly improved access of exporters from CEECs to EU markets, especially, for industrial products. GSP preferential rates embraced 63 percent of all CN tariff lines in EU imports with most of them (94 percent of GSP items) subject to zero rates.¹⁷ This share was higher for industrial products and amounted to 74 percent with all GSP preferential rates for these products equal zero. As a result, the share of exports with duty-free access almost doubled from around 18 percent to about 35 percent (Kaminski 1993). Other measures including the removal of specific quantitative restrictions and suspension of non-specific restrictions (excluding imports of agricultural products, textiles and steel) in 1990 and 1991; the elimination of quantitative restrictions (excluding exports to Benelux, Germany and Italy) on steel and iron imports; and increases in textile and clothing quotas have also improved access for products originating in CEECs.

Second, the interim trade component of EA overshadowed GSP arrangements by retaining preferential tariffs and making them permanent rather than subject to annual reviews. In

¹⁶ See *Trade Relations between the European Community and South Eastern Europe*, Discussion Paper, Stability Pact: Meeting of the Economic Working Table, Brussels, 9 October 1990.

¹⁷ An important caveat is that many of these imports are subject to GSP preferential rates within limits and above them to MFN rates. As a result, their significance may be overstated.

consequence, one source of uncertainty concerning future conditions in market access, which usually negatively affects FDI inflows and other export-oriented investments, has been removed.

Hence, since at least around 1990-92 all CEEC have been close to the top of the EU preferential pyramid. Market access in accordance with trade provisions of the EA went into effect in 1992 for the former Czechoslovakia, Hungary and Poland, in 1994 for Bulgaria and Romania, in 1995 for the Baltic States, and in 1996 for Slovenia. Countries that signed EA after Czechoslovakia, Hungary and Poland either enjoyed the GSP status or special preferential access as Slovenia did under autonomous trade preferences under the 1980 agreement between the EU and former Yugoslavia.

As regards changes in market access for the CEECs, the major provisions—including subsequent amendments increasing the pace of removing tariff barriers—involved (i) full liberalization of market access for industrial products within five years after entry in force of the Interim Trade Agreements (ITA); (ii) elimination of quantitative restrictions on industrial products on the date of entry into force of the ITA except for MFA-bound textiles and clothing products, as well as products listed in the Treaty of the European Community of Coal and Steel; (iii) granting of tariff and/or tariff and ceiling quota concessions on industrial imports following various transition schemes; (iv) elimination of some quantitative restrictions on agricultural imports upon entry in force of the ITA while other restrictions will be either gradually liberalized or maintained pending the outcome of the Uruguay Round and the reform of the Common Agricultural Policy (CAP); (v) limiting the increase in agricultural imports to 10 percent in each of the next five years; and (vi) reduction of duties on listed food products.

The schedule of the removal of barriers to imports from CEEC was accelerated. Suffice here to note that by 1 January 1997 all duties on industrial products were abolished and on 1 January 1998 all remaining quantitative restrictions (textile and clothing) on imports originating in CEECs were dismantled (WTO 1997, p. 61).

Duty-free access gives an extra edge over competitors equal to the MFN (Most Favored Nation) tariff rate for a given item. Admittedly, the EU has an extensive web of preferential arrangements with a good deal of its trading partners. In consequence, a number of preferred partners compete in EU markets with products originating in CEECs on the same footing. These agreements, however, do not cover such formidable exporters as East Asian countries (including China), United States, Canada, and exporters with the potential to compete in many similar products such as states that emerged from the dissolution of the Soviet Union. Exporters from these countries are subject to MFN treatment.

Thus, it seems that preferential access has helped CEECs to expand their exports to the EU and find a new niche in international division of labor organized around the EU. Interestingly, the largest gains in exports to the EU were originally in products not subject to extensive liberalization measures (Kawecka-Wyrzykowska 1995). While initially, i.e., over 1989-93, EU turned out to be a very absorptive market for unskilled labor intensive manufactured goods, skilled labor and technology intensive drove subsequently the export expansion. Most importantly, preferential arrangements also provided an incentive to MNCs to move or establish production facilities in CEECs. As we shall see (Section 3), foreign owned firms have been largely responsible for the shift in some CEECs exports from unskilled labor intensive products to skilled labor and capital intensive products.

2.2. Geographical reorientation of trade

Geographic reorientation of trade towards patterns driven by markets rather than politics occurred relatively quickly. Since the scope and factors underlying the shift in CEEC patterns have been extensively documented elsewhere (Brenton and Gros, 1997; Kaminski, Wang and Winters, 1996; Landesmann, 1995; Michalopoulos, 1999, Smith, 2000), for the purpose of this discussion two comments will suffice. First, trade linkages among CEEC contracted dramatically following the demise of the CMEA and still remain very weak. The share of this trade increased between 1989 and 1993 from 8 to 13 percent, but mainly because of the dissolution of Czechoslovakia. The bulk of intra-CEEC trade takes place between the Czech Republic and Slovakia, which until 1992 had been part of the same national economy. Combined exports from Czech Republic and Slovakia to CEEC account for around two thirds of intra-CEEC exports. With the Czech-Slovak trade growing slower than trade with other partners, the intra-CEEC share has been on the decline since 1995. Furthermore, it is worth noting that non-manufactures play a larger role in intra-CEEC trade relative to that with the EU.

Second, the EU, or rather Germany alone, has replaced the former Soviet Union as the major trading partner for all CEEC. The share of the EU in CEEC exports rose from around one third in 1989 to 60 percent in 1993 and has been flat thereafter. Germany's demand for CEEC products dramatically increased in large part because of unification. The share of Germany in CEEC exports rose from 11 percent in 1989 to 29 percent in 1993, which accounted for more than 50 percent of EU imports from the region. Aggregate CEEC exports more than doubled over 1993-99, albeit there was some variation in countries' export performance (Table 1).

Interpretation of data on CEEC export growth needs some elaboration. Although Estonia experienced the largest increase, the base was very low in contrast, for instance, to Hungary.

Nonetheless, the performance of both has been superior. Romania had impressive gains over 1993-99 but these should be assessed against the contraction of almost 50 percent in the value of their exports over 1991-93. Poland's growth was not impressive but there are two caveats—the value of exports almost doubled during transformational recession in 1990-91 and there has been a buoyant growth in domestic demand.

Table 1: CEECs total EU-oriented exports in 1993, 1998 and 1999 (in percent and million of US dollars)

	1993	1998	1999	Index (value of exports) 1999, 1993=100
	(in million of US dollars)			
Bulgaria	1,189	2,529	2,315	195
Czech Republic	6,502	16,325	17,859	275
Estonia	307	2,036	2,201	720
Hungary	5,698	16,672	18,459	324
Latvia	901	1,781	1,649	183
Lithuania	862	1,666	1,811	210
Poland	9,816	18,291	18,687	190
Romania	2,070	5,899	6,310	305
Slovak Republic	1,643	6,092	6,091	371
Slovenia	3,671	5,822	5,831	159
TOTAL (million of US \$)	32,656	77,113	81,212	249

Source: Derived from UN COMTRADE database as reported by the EU and IMF Directions of Trade database for 1999.

Trade dependence on the EU varies, however, with the Luxembourg group (i.e., first wave entrants including Czech Republic, Estonia, Hungary, Poland, Slovenia) trading significantly more with the EU than the Helsinki group. In 1998 the simple average for the former was 71 percent on the import side and 67 percent on the export side.¹⁸ Note that these averages are higher than the share of intra-EU to external-EU trade (around 62% over 1993-98). This indicates that these countries are more integrated into the EU in terms of trade than some EU members. Countries, which have been later included in the Helsinki-wave of EU accession, trade less with the EU than the Luxembourg group. They had average shares of 50 and 59 percent respectively. This group had a much larger dispersion, mainly because of Romania's much higher dependence both on exports (65%) and imports (62%) from the EU than of other countries in this group.¹⁹ Following the 1998 Russian financial-meltdown, there are indications that the share of the EU in trade of the Berlin group is catching up with the average for the first-wave group.

¹⁸ Own calculations derived from IMF Direction of Trade statistics.

¹⁹ Standard deviation is 3.3 for both exports and imports for the first-wave candidates and 7.6 for both export and import shares for other European associates.

2.3. Emerging position in regional division of labor: shift towards more advanced stages of production

The EU has not become CEECs' major trading partner by default, that is, simply because of the collapse of CMEA trade. Following the transformational recession during the initial stages of transition, the aggregate value of CEEC total exports rapidly expanded almost doubling from US \$49 billion in 1993 to US \$94 billion in 1998. Manufactured products were responsible for the growth with their share in total CEEC exports increasing from 70 percent to 75 percent over the same period.

Perhaps the most important change over 1989-99 was the transformation in CEEC position in the international division of labor. While before the collapse of central planning CEECs were mainly suppliers of simple raw materials to OECD economies, patterns of their foreign trade through the 1990s point to their involvement in finer division of labor based on production sharing. The share of such traditional production—essentially unprocessed—inputs as agricultural raw materials, ores, minerals, non-ferrous metals in total exports dramatically declined while that of manufactured components expanded (Box 1).²⁰

This shift is more remarkable considering that trade with the EU rather than with less developed countries has been its main driver. While redirection of exports from CMEA to EU markets was initially responsible for it, industrial restructuring and improvements in corporate governance sustained this change in highly demanding and competitive EU markets. Consider that the share of manufactured components increased from 6 percent in 1993 to 11 percent in 1997 while this share in total exports rose from 6 to 9 percent (Table B1). Hence, the growth in exports of manufactured components to the EU more than offset the apparent stagnation in exports to other markets. In consequence, CEECs are no longer suppliers of traditional inputs to the EU and mere recipients of products processed there as was the case under central planning.

Manufactures have been the driving force of CEEC exports to the EU. Their share in each CEEC exports dramatically expanded in the aftermath of the collapse of the CMEA (Kaminski 1994). In order to assess the depth of change and make some inferences about emerging patterns of specialization, an examination of changes in the composition of trade in terms of 'end-uses' provides a good point of departure. The use of the 'end-use' categories of the US Bureau of Economic Analysis allows identification of products by their use by buyers rather than in terms of their positions in production process (Irwin, 1996). The composition of trade in

²⁰ One might argue that this growth was simply the result of re-direction of exports from CMEA markets to EU markets. But a simple re-direction occurred earlier in 1990-91. The increase in exports over 1993-98 was bound to come from re-tooled capacities and firms with good corporate governance.

Box 1: CEEC are no longer locked into traditional division of labor

The traditional division of labor linked least developed and highly developed countries in the world through exchanges of raw materials and low processed goods for processed ones. The least developed countries would specialize in exports of production inputs to highly developed economies, which in turn would process them and export some portion back to the least developed group. These inputs include items, which—unlike components and parts—have no discernible use in their present form and—in contrast to production sharing—are basically unprocessed. Agricultural raw materials (SITC 2-22-27-28), ores, minerals and nonferrous materials (27+28+68) may be regarded as traditional production inputs, i.e., not processed in their present form (Yeats 1998). These goods, like manufactured components, are exported (or imported) for further processing or assembling.

An interesting question is to what extent the position of CEEC in the division of labor, both global and regional, has changed since the collapse of central planning. Data in Table B1 contrasting CEEC trade in traditional production inputs with total and EU trade and trade in manufactured components (parts as identified in Standard International Trade Classification in Section 7) attest to the remarkable shift that has occurred since 1989 in CEEC 'rules of engagement' in international commerce. Both total trade and especially trade in parts have been growing much faster than trade in traditional production inputs. It recorded the fastest growth in exports to the world and EU markets as well as in imports.

Table B1: Traditional versus 'non-traditional' trade of CEEC, 1993 and 1997

	Trade Value in \$ Million		Value Index 1993=100		Share in percent		Memo: Trade Balance as % of exports	
	1993	1997	1993	1997	1993	1997	1993	1997
Total Imports from World								
Traditional Production Inputs	2,281	5,085	100	223.0	4.0	4.1	50.0	30.1
Manufactured Components	5,822	16,520	100	283.7	10.3	13.3	-108.8	-87.2
All Goods	56,511	124,384	100	220.1	100.0	100.0	-15.1	-32.1
Total Exports to World								
Traditional Production Inputs	4,564	7,273	100	159.3	9.3	7.7		
Manufactured Components	2,789	8,823	100	316.4	5.7	9.4		
All Goods	49,088	94,180	100	191.9	100.0	100.0		
Total Imports from EU15								
Traditional Production Inputs	1,333	2,453	100	184.0	3.3	3.1	59.7	52.7
Manufactured Components	4,404	13,384	100	303.9	10.8	16.7	-122.1	-103.7
All Goods	40,711	80,361	100	197.4	100.0	100.0	-22.8	-33.4
Total Exports to EU15								
Traditional Production Inputs	3,307	5,182	100	156.7	10.0	8.6		
Manufactured Components	1,983	6,569	100	331.3	6.0	10.9		
All Goods	33,149	60,247	100	181.7	100.0	100.0		

Source: Own calculations based on partners' data as reported to UN COMTRADE database.

While in 1993 the value of exports of traditional production inputs was almost twice as large as that of manufactured components, in 1997 this value was 18 percent lower. The share of manufactured parts in CEEC total exports to the world rose from almost 6 percent in 1993 to above 9 percent in 1997. These developments indicate a very fast process of re-integration of CEEC into international markets. It thus appears that CEEC are no longer locked in a traditional division of labor.

terms of 'end- use' categories provides information about the level of economic development and a country's position in international division of labor. Respective shares of various categories in both exports and imports indicate the extent to which domestic firms participate in more advanced stages of production (Feenstra 1998).

Most trade occurs in the five categories as presented in Table 2. These include foods, feeds and beverages; industrial supplies and materials; capital goods (excluding automotive vehicles); consumer goods (except autos); and automotive vehicles and parts. The industrial supplies and materials include mainly raw materials but also some basic manufactured goods such as steel, newsprint, textile yarns, etc. The capital goods are used for both investment and as intermediate products (all electrical parts and components except finished consumer goods are regarded as capital goods). The consumer goods are finished household products.

Several studies have pointed to the shift away from agriculture and raw materials to industrial supplies and materials in trade of highly developed countries. Feenstra (1998) notes that while the share of food and beverages and industrial raw materials accounted in 1925 for almost 82 percent of U.S. imports, it fell to only 23 percent in 1995. Quite a dramatic change that had been brought about mainly by imports of capital goods, whose share grew from 0.4 percent in 1925 to 7 percent in 1965 and 34 percent in 1995. Is similar change underway in trade of CEEC with the EU absorbing almost two-thirds of its exports?

Several observations can be drawn from data tabulated in Table 2. The most general one is that CEEC exports and imports increased much more than those of the European Union. In consequence, CEEC as a region has become the second largest—after the U.S.—importer of EU products. With the value of imports of almost US\$100 billion in 1998, its share in EU-external exports increased from 5 percent in 1993 to 8 percent in 1998. The share in EU external imports also increased rather considerably from 4 to 6 percent over the same period.

Second, the composition of CEEC trade in terms of end-use categories with the EU has been converging towards that of the EU. This process has two aspects. It involves the growing similarity between composition of exports and imports of CEECs and the similarity between respective compositions of EU trade and CEEC trade with the EU. While both suggest the process of catching up, the first is the product of a two-way intra-industry trade—because of more diversified consumer taste and production needs, exports and imports of products from the same group grow. The process of catching up with the EU seems to explain the growing similarity between the EU and CEEC compositions of trade, while the closing of gaps between CEEC export and import composition points to industrial restructuring. By these two measures, CEECs

scored much higher than Turkey, whose export composition in 1989 did not deviate much from that of aggregate CEEC exports in the same year.

The most rapid closure of differences in respective export and import shares occurred in two product categories—capital goods and automotive products. Note that the closure did not involve a relative decline of CEEC imports from the EU. It occurred thanks to rapidly expanding exports—the value of exports of automotive sector increased more than five-fold and exports of capital goods rose more four-fold.

Table 2: Change in the composition of CEEC and Turkey's trade with the EU in terms of end-use and the EU's trade with the world, 1989, 1993, 1997 and 1998

		CEECs		Turkey		European Union		Share of CEEC in EU	
		Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports
All Goods (in million of US dollars)	1989	12,449	11,755	6,581	6,464	800,241	804,650	1.47	1.55
	1993	33,149	40,711	8,242	14,306	850,575	893,121	4.79	3.71
	1997	60,248	80,364	13,077	24,112	1,136,715	1,239,006	7.07	4.86
	1998	77,113	99,157	15,121	23,424	1,235,692	1,315,128	8.02	5.86
Index 1998, 1993=100		233	244	183	164	145	147	168	158
Food, Feeds and Beverages (in percent)	1989	18.6	10.5	14.7	5.3	10.9	11	1.42	2.62
	1993	8.5	9.4	16.9	2.7	12.4	12.3	3.63	2.56
	1997	5.2	5.9	15.8	3.0	11.1	10.7	3.76	2.36
	1998	4.4	5.4	13.6	2.9	10.7	10.4	4.05	2.48
Index 1998(value of exports), 1993=100		120	140	148	176	125	125	112	97
Industrial Supplies and Materials (in percent)	1989	28.3	6.1	18.8	9	10.2	9.8	0.88	4.47
	1993	18.3	6.1	7.3	8.4	8.9	8.4	3.28	8.09
	1997	13	5.3	5.7	7.3	8.3	7.7	4.51	8.21
	1998	11.2	4.6	5.2	5.8	7.0	6.6	5.27	9.95
Index 1998(value of exports), 1993=100		142	184	131	113	114	116	161	123
Capital Goods (excluding Motor vehicles) (in percent)	1989	8.3	29.5	3.8	35.9	22.8	23.9	1.90	0.54
	1993	13.5	28.3	7.3	36.3	21.8	23.3	6.21	2.15
	1997	22.3	31.1	10.7	35.9	23.6	25.9	9.32	4.19
	1998	25.7	32.2	12.7	37.9	24.9	26.5	10.38	5.69
Index 1998(value of exports), 1993=100		443	277	319	171	166	167	167	264
Consumer Goods (excluding Automobiles) (in percent)	1989	42.6	48.2	61.5	43	44.4	43	1.59	1.53
	1993	54.6	46	67.1	40.3	44.5	44.1	4.95	4.60
	1997	50.8	45.8	65.3	39.6	43.1	42.8	7.51	5.77
	1998	47.4	47.6	65.3	40.7	42.8	42.5	8.92	6.54
Index 1998(value of exports), 1993=100		202	252	179	165	140	142	180	142
Automotive: vehicles and parts (in percent)	1989	1.8	5.8	1.2	6.8	11.7	12.2	0.73	0.23
	1993	5.1	10.2	1.3	12.4	12.4	11.8	3.94	1.60
	1997	8.7	11.9	2.5	14.2	13.9	12.9	6.05	3.28
	1998	11.2	10.1	2.9	12.0	14.3	13.8	5.67	4.76
Index 1998 (value of exports), 1993=100		511	241	409	158	168	172	144	297

Source: Own calculations based on data reported by the EU to UN COMTRADE database.

The still existing disparities between EU and CEEC baskets in terms of end-use categories are most visible in foods, feeds and beverages and industrial supplies and materials. The share of foods, feeds and beverages in CEEC exports to the EU has been falling. So has their share in EU-external imports, albeit at a slower pace (Table 2). The CEECs continue exporting relatively more of industrial supplies and materials than the EU does, but the difference has been on the decline. It fell from 11 percentage points in 1989 to 8 in 1993 and 4 in 1998. Although the share of industrial supplies and materials declined over 1989-98, their share in EU external imports increased from 5 percent to 10 percent over this period. Nonetheless, the combined share of food, feeds, beverages and industrial supplies in CEEC imports has moved very close to that of the EU.

Third, data in Table 2 point to a definite shift in CEEC EU-oriented exports from agriculture-based products and industrial raw materials towards manufactured goods. The shares of the latter significantly increased, whereas these of the former declined. The combined share of foods, feeds, beverages and industrial supplies fell from 47 percent in 1989 to 27 percent in 1993, 21 percent in 1997 and 16 percent in 1998.²¹ On the import side, the aggregate share of agricultural products and industrial supplies declined between 1989 and 1993 from 17 to 16 percent and to 10 percent in 1998.

In all, the major conclusion that can be drawn from data presented in Table 2 is that products traded by CEECs are at increasingly advanced stages of production on both export and import side. Under central planning CEEC's non-CMEA links followed the pattern of a traditional division of labor—they essentially exchanged with highly developed countries raw materials and low processed inputs for processed manufactures. This situation seems to have changed rather dramatically in the 1990s. Their trade suggests the increase in importance of processed manufactures at the expense of raw materials and agricultural products. These developments indicate a very fast process of re-integration of CEEC into international markets following the demise of central planning with sizable benefits to CEEC and EU firms alike.

2.4. Factor content of EU-oriented exports

According to Heckscher-Ohlin Theorem, commodity trade patterns reflect differences in comparative advantage as determined by different factor endowments among countries. A country tends to export those goods that use factors in relative abundance—an outcome of a

²¹ The comparison of CEEC shares between 1989 and 1993 has to account for the emergence of four new states by 1993. The data also does not include trade with partners who did not report to the UN COMTRADE database. Among these the most important is the absence of data on trade with what was the Soviet Union.

competitive market mechanism efficiently allocating resources. Exploring a full causal chain linking factor endowments with comparative advantage and trade pattern is not relevant for this discussion. The question germane here concerns broad changes in relative factor intensities as revealed in exports to the EU.

We break commodity groups as classified in the SITC (Rev. 1) into four groups reflecting their distinct relative factor intensities (Krause 1986). These groups are natural resource based, unskilled labor intensive, technology intensive and skilled labor intensive products. The goodness of results obtained hinges critically on the quality of a classification used to examine export baskets over time by factor mix. The advantage of the classification used here is that all industries are taken into account and a four-digit industry appears only in one classification. Its weakness is that some industries may be intensive in terms of more than one factor. Although this may clearly distort the results, one may identify on this basis broad lines of change occurring in export offer over time.

The two groups—natural resource based and unskilled labor intensive products—tend to represent lines of production characterized by low value added, high natural resource content and simple technologies. They usually account for a dominant share of exports in countries that are at the lower level of economic development. While the line dividing the capital intensive and skilled labor intensive groups is fuzzy, they both contain products requiring more sophisticated inputs than those found in the first two groups. Capital based sectors are, however, characterized by larger R&D spending than skilled labor intensive industries.

Considering CEECs' large pool of relatively low-cost labor and its moderate climate conditions favoring agriculture, one would expect that labor-intensive products together with natural resource intensive products would dominate its export basket. Adding to that the abundance of highly skilled labor relative to their GDP per capita, skilled labor-intensive products within labor intensive products should account for a sizable allotment.

The change in the composition of CEEC's EU-oriented exports in terms of factor intensities corroborates these expectations, albeit with a delay. Over 1989-93 unskilled labor intensive industrial goods drove CEEC reorientation of trade towards the EU (Table 3). This share doubled in Bulgaria's exports (from 16% to 31%) and significantly increased in exports from Hungary (from 19% to 27%), from Poland (from 17% to 30%) and from Romania (from 36% to 62%).

Although unskilled labor intensive products still account for a dominant portion of CEEC exports to the EU, their share was on the decline over 1993-97.²² So was the share of natural

²² The exception is Bulgaria. Its export behavior in terms of factor intensities resembled that of other fast-reforming CEECs until 1996, albeit for a wrong reason, i.e., subsidies. With the cut of export

resource intensive products that were of major importance under central planning in the 1980s. The share of skilled labor intensive products in total EU-oriented exports from CEEC rose from 26 percent to 29 percent (Table 3).

Table 3: Factor intensities of CEECs' exports and imports from the EU, 1989, 1993 and 1997

Product categories	Exports to the EU				Imports from the EU			
	1989 ^A	1993	1997	Index 1997 1993=100	1989 ^A	1993	1997	Index 1997 1993=100
Natural Resource	50.6	33.6	23.8	130	20.4	18.9	15.0	156
Unskilled Labor	21.6	29.5	25.8	160	12.3	17.2	16.2	186
Capital Intensive	14.5	17.3	25.7	271	45.5	37.9	40.2	210
Skilled Labor	13.2	19.6	24.6	230	21.8	26.0	28.7	218
All Goods (in US\$ million)	12,294	32,655	59,661	183	11,522	39,997	79,135	198

^A For 1989, data available only for Bulgaria, former Czechoslovakia, Hungary, Poland and Romania.

Source: Own calculations based on data reported by the EU to UN COMTRADE database.

The gap between CEEC endowment in highly skilled labor and factor content of their exports has been closing. The value of these exports in 1997 was 130 percent over its 1993 value and the value of technology based exports was 171 percent over its level in 1993. Note also that the growth of technology and skilled labor intensive products was much faster than that of natural resource and unskilled labor intensive products. In consequence, the aggregate share of skilled labor intensive products and technology intensive products in EU-oriented exports increased from 37 percent in 1993 to 50 percent in 1997.

Similar trends in CEEC imports from the EU provide strong argument about significant returns stemming from integration into EU markets. The most dynamic component of their imports are products with high content of technology and human capital. These products embody knowledge and have similar effect as technology transfers. Their imports increased considerably more than resource- and unskilled labor-intensive products over 1993-97. Juxtaposing this with our earlier finding that imports of capital equipment recorded the largest increase among end-use product categories suggests a very significant progress in integration into EU markets at increasingly more sophisticated levels.

But the progress has been uneven among CEECs, although their trade with the EU shares the same dynamic characteristics. First, the shift in composition of their trade indicates growing participation in more sophisticated and higher value-added production activity.

Second, this participation has been generating demand in EU markets for skilled labor intensive and technology based products. In fact, these two categories of products have shaped the

subsidies following the implementation of a radical stabilization-cum-transformation program in 1997, exports of unskilled labor intensive products became the driving force of Bulgarian EU-oriented exports.

dynamics of CEEC exports to EU markets. The share of high skilled labor intensive and technology-based products exceeded 50 percent in exports of the Czech Republic (62%), Hungary (67%), Slovakia (62%) and Slovenia (57%). The scope of change is best illustrated by the fact that except for Slovenia there was no other CEEC in 1993 with the aggregate share of these exports exceeding 50 percent!

The developments in foreign trade of CEEC indicate a dramatic change in their position in international division of labor, which has become organized largely around their most important trading partner—the EU. While initially, i.e., over 1989-93, EU turned out to be a very absorptive market for unskilled labor intensive manufactured goods, skilled labor and technology-based, capital intensive products have driven subsequently export expansion of most CEECs.

The reorientation of geographical patterns of trade from the former CMEA and Soviet Union (former Yugoslavia for Slovenia) accompanied by a large increase in both exports and imports of manufactured goods has produced a high degree of mutual interdependence in EU-CEEC trade. This shift towards trade involving more advanced stages of production has an important political economy implication. Mutual interdependence tends to weaken protectionist interests as both exporters and importers increasingly share in gains. Increases in intra-industry trade and intra-product trade based on production fragmentation have similar impact. Exporters and importers tend to operate in the same industries as firms operating in global cycles of production of MNCs and any disruption in this trade would produce losses with no respect for national borders. Therefore, they constitute potentially a strong anti-protectionist lobby in both EU countries and CEECs.

Moreover, further growth in trade will produce smaller dislocation of resources considering that already a large portion of their trade is of intra-industry type or more specifically involves intra-product trade generated by fragmentation of production.

3. FDI and integration into the EU

Integrationist accords, even those limited to trade, enhance credibility of the government in a transition economy in terms of commitment to economy-opening reforms. The accords do not have to have special clauses on treatment of foreign investment to serve as credibility-enhancing mechanism: a domestic liberal regime obtains an extra credibility when a country becomes party of the agreement with a highly developed partner. The impact of the policy-induced integration process on foreign capital inflows is twofold. First, by reducing the risk that foreign investor face and improving a country's business climate, they increase the flow of direct

and portfolio investment often diverting them from other regions.²³ Combined with additional incentives associated with the improved access to markets of developed countries, the increased inflows may be quite considerable. These can be driven by the desire of firms to overcome trade barriers and take advantage of emerging economies of scale.

Second, the increased foreign participation in investment outlays contributes to a faster industrial restructuring based on better technologies and know how as well as improvement in corporate governance. An important aspect of foreign investment, often neglected in dominant economic commentary, is the fact that FDI allow for easier access to international markets through distribution channels of a parent company. Available evidence suggests that establishing presence in international markets often requires expending significant resources (Roberts and Tybout 1997). Access to foreign markets is thus an important asset of foreign owned firms.

The transition from central planning to a market economy opened previously closed markets to penetration by foreign investors. Former communist countries had lots to offer: All of them had a large pool of cheap labor—both skilled and unskilled. Some (mainly countries of Commonwealth of Independent States—a loose organization encompassing 12 former Soviet Republics excluding the Baltic states) had large deposits of non-renewable natural resources and others were conveniently located close to EU. Countries that had been included in the EU integrationist project also offered preferential access to EU markets. How have these factors shaped FDI inflows?

3.1. Impact of the integration framework on attractiveness of CEECs to foreign investors

The EA-triggered integration process has offered a number of advantages with the potential for attracting foreign investors. Consider first economies of scale associated with preferential access to EU markets. The EU shortened transition periods by eliminating tariffs and quotas on industrial imports from CEECs—by 1997 CEEC exporters of manufactures had duty-free market access. Thus, investors seeking unfettered access to EU markets would also consider locating production facilities in CEECs.

Second, the EA guaranteed the right of establishment to EU firms guaranteed by the EA as well as commitments to liberalize access to services together with other provisions envisaging an orderly process of interaction between the EU and its associate members have served as a credibility-enhancing mechanism.

²³ For instance, once the process of their accession to the EU began Spain and Portugal experienced large inflows of foreign direct investment. The respective shares FDI in GDP rose from 1.1 percent and 0.8 percent in 1981-85 to 2.1 and 2.9 percent over 1988-92.

Third, provisions aligning economic regimes with those in the EU were particularly significant because their implementation amounted to the promise of an orderly transition to an economy based on competitive markets.

In addition, the EA contained a special provision allowing CEECs to use a duty drawback, that is, refunding exporters to the EU for duties paid on imported inputs. This was quite an unusual arrangement since FTAs as a rule prohibit their signatories the use of drawback in their mutual exports. With a drawback scheme in place, a domestic firm (in this case the EU one) would have to compete with a firm from the FTA partner (CEEC) on unequal footing. For instance, if two firms, one from the EU and another from CEEC, producing the same final product import intermediate inputs from a third country, then a CEEC firm under a duty drawback regime would have an edge over the EU supplier in EU markets. With some modifications, this provision was in place until the Pan-European Cumulation Agreement, which is based on the principle of non-drawback, went into effect in 1997-98.

While the rationale for this exemption was to strengthen CEEC competitiveness in EU markets, the provision had provided CEECs with an extra tool to attract foreign investors. It offered investors from third countries targeting EU markets saving on import duties that would have to be paid had the investment been in the EU. Since during the initial stages of a project imports often tend to be quite significant as many intermediate products are brought from a home country, this was an extra incentive for third country investors seeking to jump tariff barriers in the EU. But this arrangement has probably also triggered interest among EU producers, especially those heavily relying on imports from third countries in their production for EU markets. It has provided them with an extra incentive to move production to a CEEC.

On the other hand, the framework had two potential shortcomings, which—it seems with the benefit of hindsight—did not unfold. First, some analysts feared that the framework would offer a back-door entry for vested interests pressing for higher levels of government intervention in the economy and thus encourage the shift to managed trade.²⁴

Second, the integration framework has not closed the option to the EU of resorting to protectionist measures. Indeed, there were a number of easy exits increasing the scope of contingent protectionism, which usually deters investment (Rollo and Smith, 1993). Actual developments, however, did not confirm these fears as there is little, if any empirical evidence that the above shortcomings negatively affected FDI inflows either because of contingent protectionism or distortions generated by managed trade.

²⁴ For the latter point, see Messerlin (1992).

The framework had, however, two more serious weaknesses—both of them related to the rules of origin used to determine goods and services entitled to preferential treatment. While no counterfactual evidence is available, it is quite likely that they deterred many investors. First, the rules of origin were rather restrictive for non-EU investors. Note that during the initial stages, production often requires massive use of imported intermediate products and components. As a result, many potential investment opportunities might have been lost—a point of considerable consequence given the relatively large involvement of non-EU firms in investment in CEEC. Winters (1993:13) argued that restrictive rules of origin “... effectively preclude many non-EU firms from establishing viable plants in the Central and Eastern European countries.” It seems that simplifying and decreasing “local content” requirement would have had a positive impact on industrial restructuring in CEECs.

Second, bilateral (subsequently diagonal for CEFTA founders) rules of origin exacerbated negative impact of the hub-and-spoke pattern on CEECs. Until 1997-98 when a new system of rules of origin under the Pan-European Cumulation Agreement went into effect, EU firms had little incentive to locate production units of the same supply chain in different CEECs or to outsource to firms in other CEECs.

The advantages of the policy-induced integration into the EU in terms of attracting FDI clearly outweigh the above-discussed shortcomings. Duty-free access to EU markets and transformation of economic regimes towards meeting the requirements of the *acquis* have clearly increased the attractiveness of CEECs to foreign investors. The advantage to a recipient country is that FDI usually contribute to the development of a two-way inter-industry trade and often integrate established production facilities into global networks of production and marketing, which in turn gives rise to intra-product trade (Kaminski and Ng, 2000).

This type of trade derived from production fragmentation, mainly carried out by MNCs (multinational corporations), offers several benefits: It gives direct access to larger markets allowing exploitation of economies of scale. It boosts exports without firms incurring investment in establishing market presence. Last but not least, it offers greater stability in earnings thanks to a global reach of a “parent” company.

3.2. FDI flows to CEECs: sources of variation

Indeed, notwithstanding these imperfections, transition economies received on average more capital inflows in terms of per capita than most developing countries (Garibaldi et al. 1999). But within transition economies there was a significant difference between CEECs and former Soviet republics (excluding the Baltic States) economies. While over 1990-97 all transition

economies received around US\$ 64 billion in FDI, US\$ 49 billion (or 77%) went to CEECs. As Havrylyshyn and Wolfe note, "... even those CIS countries that have enjoyed consistent growth have not attracted anything like the same amounts of foreign direct investment." (1999:14). Considering that Russia alone is larger in terms of GDP and population than CEECs combined, the difference is startling. Claessens, Oks and Palastri (1998) attribute this difference to what they call the "EU-factor."

Table 4: FDI flows to CEEC over 1990-99 (in million of US dollars) and FDI per capita (in US dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	TOTAL 1990-99	GDP per capita 1998 (in US dollars)
Bulgaria	4	56	41	40	105	90	109	505	537	734	2,221	1,140
Czech R.	207	400	600	654	878	2,568	1,435	1,275	1,567	1,768	11,352	5,200
Estonia	0	0	82	162	214	202	150	130	489	566	1,995	3,330
Hungary	311	1,462	1,479	2,350	1,144	4,519	1,982	1,785	1,454	1,027	17,513	4,430
Latvia	0	0	29	45	214	180	328	515	220	208	1,739	2,430
Lithuania	0	0	10	12	31	73	152	328	1,075	1,041	2,722	2,230
Poland	89	291	678	1,715	1,875	3,659	4,498	3,041	6,164	6,180	28,190	3,590
Romania	0	40	77	94	341	419	263	1,224	1,598	1,716	5,772	1,420
Slovenia	0	0	111	113	84	170	186	321	165	255	1,405	9,680
Slovakia	18	82	100	199	203	183	330	161	508	275	2,059	3,700
TOTAL	625	2,275	3,166	5,344	4,984	11,973	9,324	8,780	13,240	13,036	72,747	
	per capita (in US dollars)										TOTAL 1990-99 per capita	Share of the total in 1998 GDP (in %)
Bulgaria	0	7	5	5	13	11	13	60	64	87	265	15.5
Czech R.	20	39	58	63	85	249	139	124	152	172	1,102	17.9
Estonia	0	0	55	108	143	135	100	87	326	378	1,330	28.6
Hungary	30	143	145	230	112	443	194	175	143	101	1,717	36.5
Latvia	0	0	12	18	86	72	131	206	88	83	696	25.2
Lithuania	0	0	3	3	8	20	41	89	291	281	736	20.4
Poland	2	8	18	44	49	95	117	79	160	160	730	15.9
Romania	0	2	3	4	15	18	12	54	70	76	254	12.6
Slovenia	0	0	56	57	42	85	93	161	83	128	703	5.9
Slovakia	3	15	19	37	38	34	61	30	94	51	381	8.9
TOTAL	6	22	30	51	47	114	89	83	126	124	691	
Coefficient of variation ^{1/}	1.91	2.07	1.20	1.23	0.79	1.17	0.65	0.55	0.63	0.69	0.60	0.49

Note: ^{1/} coefficient of variation is the ratio of standard deviation to the average.

Source: *Economic Survey of Europe 2000* No. 3, Economic Commission for Europe, United Nations, New York and Geneva 1999; and *Global Development Finance 1997*, The World Bank, Washington DC 1998.

While the "EU-factor" is a good candidate to explain the startling difference between CEECs and former Soviet republic, it would fail to explain the variation in FDI inflows to CEECs over 1990-99 (Table 4). Geography, for starters, has clearly mattered. With the unification of

Germany in 1991 and EFTAN enlargement of the EU in 1995, the number of CEECs directly bordering with the EU has significantly increased. With the exception of Bulgaria and to some extent Romania, geography works strongly in favor of other CEECs. Only Romania and Baltic states (though they have easy access to convenient sea links) do not border the EU.²⁵

Other CEECs have superb geographical location. A 60 mile line from the border of the EU captures almost the whole territory of Slovenia, around 50 percent of the territory of the Czech Republic, one-fourth of the territory of Slovakia and an area almost reaching Budapest—the capital and industrial center of Hungary (Kierzkowski 2000). Geography suggests that these countries along with Poland's western region are potentially the location for the maquiladoras of the EU in the same way as Mexican areas bordering the U.S. are for US MNCs.

Data tabulated in Table 4 indeed suggest that countries well within the reach of a 60-mile boundary obtained the bulk of FDI inflows, albeit with a caveat. By this criterion alone, the Czech Republic and Slovenia should have been the major recipients. But this was not the case in the 1990s, as Hungary and Estonia received significantly larger FDI flows on a per capita basis. The Czech Republic ranks third and Slovenia ranks sixth among 10-CEECs. Bulgaria and Romania, who ranked 9th and 10th respectively, obtained significantly lower per capita FDI inflows than Latvia and Lithuania.

Yet, the variation in FDI flows to CEECs fell over 1996-99, as the values of the coefficient of variation (ratio of standard deviation to weighted average) for FDI inflows (last row in Table 4) standardized by the coefficient of variation of GDP per capita in 1997 indicate. Hungary attracted the largest inflows per capita among CEECs over 1990-96 except in 1994 (Estonia). But subsequently the annual inflows of FDI to Hungary were falling, whereas other countries—Baltic states, Poland, Bulgaria and Romania—began attracting FDI in 1996-99. Hence, CEECs neglected during initial stages of transition have become significant recipients of foreign investment.

Institutional environment, the mode of privatization, and the record of servicing sovereign debt seem to be among most important factors explaining the variation in FDI inflows. Institutional environment appears to stand out. Using a rigorous econometric analysis Garibaldi et al. (1999) show that legal and political climate rather than macroeconomic fundamentals have shaped FDI flows to transition economies. It appears that macroeconomic stability without business friendly environment was not enough to attract foreign investment. Claessens, Oks and

²⁵ Although Bulgaria has a common border with the EU, economic benefits are rather negligibly as Greece is the poorest member of the EU.

Palastri (1998) arrive at a similar conclusion linking progress in economic reforms with FDI. Kaminski (2000) corroborates this result.²⁶

The choice of the mode and scope of privatization as well as debt-servicing record favored Hungary during the initial stages of transition (Kaminski and Riboud 2000). The decision not to default on its foreign debt put to rest the debate about ‘dangers’ of foreign capital in Hungary. Hungary opted for privatization to an outside investor, and opened the so-called strategic sectors (telecommunications, utilities, and financial services) to foreign investors around 4-5 years before any other CEEC was ready for this move. Privatization-related FDI flows to Hungary accounted for around 40 percent of total inflows. The Czech mass voucher privatization program erected barrier to FDI, while the Slovenian legal framework—rooted in Yugoslav worker’s self-management—turned out to keep foreign investors at bay. Despite the selection of a similar mode of privatization as Hungary—albeit initially much less radical and extensive in scope—protracted negotiations on Poland’s private debt under the aegis of the London Club kept investors away until around 1993-94.

Other considerations seem to account for Bulgaria and Romania’s poor performance in terms of attracting FDI. Proximity to war-prone former Yugoslavia did not make them an attractive location in the 1990s. But it seems that stalled reforms were the major reason. Consider that 80 percent of total inflows came to Bulgaria over 1997-99. This coincided with the war in neighboring Kosovo in 1999, but above all with the first serious effort to establish macroeconomic stability and liberalize the economy following the 1996 financial crisis and change in government.

3.3. FDI and trade with the EU

FDI are a powerful vehicle for transfer of technology and best practices in management. They also contribute to integration of domestic production capacities into global markets. The evidence from several CEECs strongly suggests that foreign firms are more foreign trade-oriented than domestic firms, thus making a relatively larger contribution to reintegration of CEECs into the world economy and especially into the EU. Foreign firms have already emerged as the largest exporters in such countries as the Czech Republic, Estonia, Hungary and Poland. In 1998 they accounted for around 80 percent of Hungarian EU-oriented exports of manufactures and 40 percent of Polish exports (Kaminski and Riboud 2000, Kaminski and Smarzynska 2000). Indirect

²⁶ He examined correlation coefficients between total FDI per capita over 1990-97, the rule of law, attractiveness to business, and inflation in 1997. There appears to be a strong positive correlation between FDI and institutional parameters, i.e., the rule of law and attractiveness to business (0.67 and 0.68), and a very weak negative correlation (-0.27) with the rate of inflation in 1997.

effects that relate to restructuring, productivity spillovers and foreign firms' contribution to the development of the export infrastructure and services are more difficult to capture. However, their impact works through lowering transaction costs and attracting other foreign firms—often customers of banks, insurance agents, etc.

MNCs are also instrumental in setting up supply chains cutting across many national borders. Trade within global production and marketing networks organized around MNCs has been the most rapidly growing component of world trade for the last two decades. As a result, inter-industry division of labor has become increasingly marginalized by a more complex specialization implicit in intra-industry trade presently enriched by *intra-product* specialization that extends the division of labor to parts and components of products within larger transborder supply chains (Kierzkowski 2000).

How have FDI affected CEEC trade with the EU? It seems that FDI have been mainly responsible for the shift from unskilled labor intensive and natural resource intensive products to skilled labor intensive and technology based products. While without access to data at the level of firms it would be impossible to give a precise assessment, available empirical evidence for Hungary and Poland suggests that FDI tend to target skilled labor and technology intensive lines of production in the CEECs (Kaminski and Riboud 2000, Kaminski and Smarzynska 2000).

Data compiled in Table 5 provide empirical support to the following general observations. First, the share of skilled labor and capital intensive products increased for all CEECs (column "c"). Estonia and Lithuania recorded particularly large increases, but from very low levels in 1993. The spectacular increase in the share of skilled labor intensive and technology from 40 percent in 1993 to 68 percent (or from US\$ 2.3 billion to US\$ 10 billion) of total EU-destined exports can be fully attributed to FDI. Note that by 1997 Hungary obtained already 54 percent of total FDI flows over 1990-99 (column "d" in Table 5) and their cumulative value accounted by 1997 to 31 percent (column "e") of the 1998 GDP. On similar grounds, one may also conclude that very significant increases in the share of these products in Czech, Polish and Slovak exports were due to FDI activity. On the other hand, Slovenia, which received the smallest amount of FDI among CEECs in terms of its GDP (column "e"), registered a relatively modest increase in these exports: their value increased from US\$ 2 billion to US\$ 3 billion and accounted for 58 percent of Slovenia's EU-destined exports in 1998.

Second, the share of intra-industry trade, i.e., two-way trade in similar products in trade with the EU, as measured by the G-L (Grubbel-Lloyd) index,²⁷ increased between 1993 and 1998 for all CEECs except Bulgaria (stagnant), Lithuania (stagnant) and Latvia (contraction) (see column "b" in Table 5). The largest increase in the value of G-L index registered Estonia

Table 5: FDI and trade, 1993 and 1998 (in US dollars and percent)

		Share in exports of networks and other parts and components in EU-oriented exports of manufactures excluding chemicals (in %)	Grubbel-Lloyd Index	Share of skilled labor and capital intensive products in EU-oriented exports (in %)	Percent of cumulative FDI in earlier year in total FDI over 1990-99 (in %)	Ratio of cumulative FDI to GDP (in %)
		"a"	"b"	"c"	"d"	"e"
Bulgaria	1993	5.7	39	32	4.5	1.5
	1998	4.1	39	35	36.4	6.7
Czech Rep.	1993	16.0	57	48	10.6	6.7
	1998	27.5	68	62	34.8	12.6
Estonia	1993	12.5	30	16	4.1	5.3
	1998	34.2	39	25	54.2	13.5
Hungary	1993	15.2	53	40	18.6	16.4
	1998	42.0	55	67	53.8	31.3
Latvia	1993	11.2	33	6	1.7	1.5
	1998	8.9	25	8	71.1	19.0
Lithuania	1993	8.6	23	13	0.4	0.5
	1998	9.6	23	25	21.5	4.5
Poland	1993	21.2	40	31	3.8	3.2
	1998	30.0	43	45	46.4	8.9
Romania	1993	18.1	28	20	2.0	0.8
	1998	9.4	32	26	38.6	5.4
Slovakia	1993	10.2	42	44	9.7	3.8
	1998	41.8	51	63	42.6	5.5
Slovenia	1993	20.1	54	51	7.9	1.7
	1998	32.5	59	58	54.2	4.1

Source: World Development Report, The World Bank and Oxford University Press, 1995 and 1999/2000, FDI as in Table 4, Kaminski and Ng (2000) and own calculations from data in the UN COMTRADE database as reported by the EU.

followed by Slovakia, Czech Republic, Romania and Poland. FDI measured in terms of the increase in their share in GDP over 1993-98 significantly increased for all of them. On the other hand, CEECs (except Latvia), which received relatively small amounts of FDI over 1990-97 (columns "d" and "e"), did not experience expansion in intra-industry trade. Evidence from other countries (Markusen 1998) as well as from transition economies in their trade with the EU

²⁷ The Grubbel-Lloyd index is the difference between unity and the quotient of the absolute difference between exports and imports of a given sector and the total of imports and exports for this sector. Calculations here are based on 4-digit SITC data.

(Hoekman 1996) suggest that increased penetration of CEECs' industrial sectors have contributed to the growth of this trade.

Changes in exports falling within global networks of production and marketing capture more adequately the role of FDI in trade than intra-industry trade as measured by the G-L index. While the G-L encapsulates a two-way trade in the same categories of products, it does not fully take into account the most dynamic ingredient of world trade occurring in international production networks organized around MNCs (Kaminski and Ng 2000). New technologies facilitate the fragmentation of production process, that is, dividing the industry's value chain into smaller functions that can be contracted out to suppliers located in different countries (Zysman and Schwartz 1998). MNCs are instrumental in setting up supply chains cutting across many national borders. Complex specialization implicit in intra-industry trade extends the division of labor to parts and components of products within larger transborder supply chains. This type of trade is often referred to as intra-product trade (Kierzkowski 2000).

The expansion in network-driven trade contributes to boosting productivity and integrates the national economy into global markets. Signs abound that CEEC producers are becoming part of this rapidly emerging global division of labor based on production fragmentation. Like highly developed countries, CEECs have also experienced a faster growth of trade in parts and components than in trade of manufactures. For instance, between 1993 and 1998 the total value of exports of parts and components from CEECs to the EU grew almost fivefold (4.8 times) while that of manufactures almost threefold (2.8 times). Imports of parts and components grew four times, while those of manufactures excluding chemicals increased less than three times (2.8) over the same period.

In order to capture fully this trade, we identify parts, components and final products in three networks usually organized around MNCs—automotive network, telecommunication equipment jointly analyzed with office equipment and automatic data processing machines (hereafter 'information revolution' network) and furniture network.²⁸ These networks have played a growing role in CEECs' trade with the EU. The share of these networks together with other parts and components in CEECs' exports of manufactures to the EU rose from 21 percent (17% coming from final products, components and parts from networks and the balance from trade in parts in other areas) in 1993 to 37 percent (31% from networks) in 1998. On the import side, the corresponding figures were 29 percent (22% in networks) in 1993 and 35 percent (26% in

²⁸ For a detailed analysis of product categories falling into each network and the method to estimate parts and components involved in production fragmentation, see Kaminski and Ng (2000).

networks) in 1998. Thus, more than one third of CEECs trade with the EU appears to relate to intra-product trade generated by fragmentation of the global production process.

But the involvement of CEECs in intra-product exchanges varies considerably across the region (see column “a” in Table 5) suggesting significant dependence on earlier FDI inflows and geographical location. The share of networks together with other parts and components in EU-oriented exports of manufactures (excluding chemical) increased for all countries of the Luxembourg group and Slovakia from the Helsinki group. While the expansion was spectacular for Slovakia (from 10% to 42%), Hungary (from 15% to 42%) and Estonia (13% to 34%), this trade drove exports of other Luxembourg countries as well. With the exception of Slovakia, the link to the size of FDI inflows and GDP per capita seems to be strong across the board.²⁹

It thus seems that foreign owned firms have already made significant contributions to integrate CEECs producers into their supply chains or transnational production and marketing networks. Geographical proximity and free access to EU markets for industrial products have made them potentially attractive for transborder relocation of production. The existing evidence suggests that some CEECs have become part of this new division of labor resulting from participation in global networks of production and distribution. Estonian and Hungarian producers in particular seem to have already become complements to EU-based production and marketing networks. But the share of network-related trade in trade of other CEECs has been also rapidly growing.

Incorporation of CEEC producers offers significant benefits to both CEECs and MNCs. For the latter, it offers a wider menu of choices in their strategies to expand their position in global markets. EU-based companies may thus become more competitive thanks to lower costs as a result of moving some production fragments to CEECs. For the former, it yields even more powerful advantages. Consider the following. First, it offers the chance of fast growth. The experience of third-tier East Asian tigers suggests that integrating into production and marketing networks of the MNCs offer the most efficient way to take advantage of growth opportunities offered by the global economy (Zysman and Schwartz 1998, p.3).

Second, it locks them into the division of labor driven by technological advances with large positive spillover effects and demonstration effects. New technologies have made possible fragmentation of production process, that is, dividing the industry’s value chain into smaller

²⁹ The correlation between FDI inflows cumulative for 1993 and 1998 and the shares of network and other parts trade in manufactured goods (excluding chemicals) is positive and relatively (0.68). Slovakia’s growth in this trade came mainly from automotive network organized around Volkswagen (Meyer 2000).

functions that can be contracted out to suppliers located in different countries. Inclusion into the production chain is usually accompanied by transfer of technology and managerial know how.

Third, it offers direct access to larger markets allowing exploiting economies of scale. It boosts exports without firms incurring marketing costs and provides greater stability in earnings thanks to a global reach of a “parent” company.

In all, expansion of network-driven trade contributes to boosting productivity in CEECs, integrating their economies into global markets and also enhanced competitiveness of MNCs in international markets.

3.4. Concluding comment

Turning to the question addressed in this section, one may conclude that the ‘EU factor’ alone could not produce magic, especially during the early stages of the integration process. It is rather the combination of the pace and scope of domestic liberalization, the approach taken to privatization of state-owned assets and preferential access to EU markets that together provides an explanation.³⁰ The EU-sponsored integration framework appears to have played a significant role but only for countries that early opted for bold and radical economic reforms.

Geography and the approach taken to dismantling central planning have ultimately driven FDI flows into CEECs. Countries that adopted a radical approach to economic reforms, sustained macroeconomic stability, opened all sectors of the economy to foreign participation and actively sought foreign strategic partners in their privatization programs have been successful in attracting FDI inflows.

But the EU-framework has helped. Leaving aside wages and productivity, liberalization of access to EU markets as stipulated in the trade component of the EA has increased attractiveness of CEEC to foreign investors. Investors from outside the EU would find location in CEEC as useful to overcome trade barriers in the EU, whereas EU-based firms might then consider moving the production from the EU without fear of deterioration in the conditions of access to their home markets. They both would take advantage of emerging economies of scale thanks to unfettered access to large markets in the EU.

³⁰ For instance, Bulgaria received very little FDI over 1989-96. Following the change in government and introduction of stabilization-*cum*-transformation program in 1997, the aggregate value of FDI inflows over 1997-99 was almost four times larger than the total for 1989-96. It seems to confirm that government commitment to economic reforms combined with the EU-integrationist framework produces synergy in terms of attracting FDI. The EU framework for integrating CEEC alone would not suffice.

Conclusion

The empirical evidence examined in this paper provides support to the view that the policy-induced integration framework has positively influenced developments in foreign trade of CEEC and has contributed to FDI inflows. But its influence is difficult, if not impossible, to assess quantitatively. Too many factors have played a role and some developments in foreign trade and FDI would have occurred independently of preferences offered by the EU. Consider the following. With the collapse of central planning and the Council for Mutual Economic Assistance, massive reorientation of trade to the EU—due to its sheer size and geographical proximity—has been bound to occur with or without preferential agreements.

So has the surge in FDI inflows. Note first that for all practical purpose CEEC were closed to FDI inflows before the collapse of central planning. Second, the 1990s witnessed a spectacular increase in FDI flows to developing countries. Hence, one might argue that even without the EU policy-induced integration FDI would come to CEEC.

Yet, some transition economies fared better than others in terms of both trade and FDI. As a region, CEECs outperformed all CIS economies, which, in part, may be explained by less onerous legacy of socialist misdevelopment in CEECs and their geographical proximity to the EU rather than the EU-integration process. But economic policies mattered, and these have been influenced by the policy-induced integration.

Consider first foreign trade institutions and policies. The policy-induced integration framework compelled CEEC to liberalize their foreign trade regimes. Although CEEC have been reluctant to open their markets on a multilateral basis (except for Estonia), regional opening has produced what now amounts to free trade regime for industrial products. The regime is not unilateral. But past estimates based on gravity model suggested that current preferential partners (without any preferences) should account for the bulk (almost 70 percent) of trade of CEEC (Winters and Wang 1994). One suspects that this proportion is higher for manufactures. Hence, most of their trade is subject to free trade rules with all efficiency and welfare gains usually associated with free trade.³¹

Economic regime friendly to private business activity is a necessary condition to attract FDI. Governments committed to liberal economic reforms would probably succeed in developing market-supporting institutions and attractive investment climate. It would also then succeed to attract foreign investors. But the “EU-associate” status has increased attractiveness thanks to preferential access to EU markets and enhanced credibility to stay reform course. With access to

³¹ Had CEEC (excluding a free-trading Estonia) adopted EU MFN applied tariffs on industrial products, these gains would have been larger as there would less trade diversion.

EU markets, the size of a domestic market mattered less. In addition, the overwhelming public support in CEEC for accession to the EU has provided reformers with a weapon to persuade investors that liberal reforms are firmly locked-in and to contain vested interest group opposed to economic reforms.

The “EU factor” did not tip the balance of political forces in CEEC in favor of radical (successful) economic reforms immediately in the aftermath of the collapse of central planning. These produced—to borrow Havrylyshyn and Wolfe (1999) distinction—virtuous cycle of economic change as opposed to vicious cycle generated by gradualism. Both radical reformers and gradualists set their policy course prior and independently of the EA. Gradualists (e.g., Bulgaria and Romania over 1990-96) failed miserably to attract FDI and improve their foreign trade performance. Major beneficiaries were fast and radical reformers.

Although the “EU factor” was not present in the choice of approach to economic reforms, it has influenced subsequent developments. It eased the pain of transition thanks to preferential conditions in access to EU markets. It has provided institutional guidance to the transition—harmonization with the *acquis* has been the principle. Last but not least, it has provided credibility to liberal reforms—an important point to investors, foreign and domestic alike. This in turn combined with preferential access to EU markets have attracted high quality FDI inflows.

The “EU factor” has been decisive in attracting FDI and consequently in shaping foreign trade of CEEC. Foreign firms seem to have been contributed to the shift in CEEC exports to the EU towards more advanced stages of production. They have been almost fully responsible for integrating some CEEC firms into global networks of production and marketing. Here the relationship is unambiguous. Those countries that attracted significant FDI inflows between 1990 and 1997 have been also among top performers in EU markets.

The process of European eastern enlargement initiated by the EA has led to significant integration of CEEC into the EU and has produced significant benefits to its participants. The CEEC, as a group, is now the second largest trading partner of the EU after the U.S., accounting for around 10 percent of its total external trade of the EU. The share of the EU in CEEC aggregate trade is around 60 percent. Except for Bulgaria, the share of this trade in other CEEC bordering the EU is higher than the share for most EU members themselves!

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